Topical Study #15
The New Wave Manifesto

By Dr. Edward Yardeni & David Moss[1] October 5, 1988

I. Introduction & Conclusions

The front cover of the April 7 issue of *The New York Times Magazine* portrays an overweight, stooping bald eagle, dressed in red, white, and blue. The old bird is holding a cane for support and staring anxiously into a small mirror. The cover story is titled "Taking Stock: Is America In Decline?"

Earlier this year, *Newsweek* ran a special front cover report, "The Pacific Century: Is America In Decline?" And at the beginning of last year, *U.S News & World Report* examined "American Competitiveness: Are We Losing It?"[2] Last year, in October's *The Atlantic*, Peter G. Peterson predicted that "America is about to wake up to a painful new economic reality, following the biggest binge of borrowing in the history of the nation.[3]

Obviously, the decline of America is a very popular subject. In his book, Alfred Malabre, Jr. Warns that "we've been living beyond our means—for so long, in fact that now, sadly, it's beyond our means to put things right, at least in an orderly, reasonably painless manner."[4] Paul Kennedy, a professor of history at Yale University, wrote a recent best seller based on the theme that "the United States now runs the risk, so familiar to historians of the rise and fall of previous Great Powers, of what might roughly be called 'imperial overstretch'…"[5] Benjamin M. Friedman, a Harvard economist and author of a new book, *Day Of Reckoning: The Consequences Of American Economic Policy Under Reagan And After*, told reporters recently that the prosperity of the last eight years was "an illusion." And , of course, Ravi Batra is still expecting a Great Depression in 1990.[6]

In this study, we will argue that the pessimists are wrong. Of course, Americans do face all sorts of challenges as we approach the next decade, and the next century. The pessimists do play a very important role in our society by identifying the problems. But they tend to exaggerate: The forces of darkness always seem to be superior to the forces of light.

The pessimistic crowd has inspired us to reexamine the economy. We believe that it is time to change the way we think about the economy because the economy has changed. The business cycle framework is useful sometimes and downright useless at other times.

---

[1] Dr. Yardeni is the Chief Economist of Prudential-Bache Securities. Mr. Moss is a history consultant to the firm and is pursuing a doctorate in history at Yale University.
[2] The *Newsweek* story appears in the February 22, 1988 issue and the *U.S. News & World Report* article was also a front cover piece in the February 2, 1987 issue.
[3] Peter G. Peterson, "The Morning After," *The Atlantic*, October 1987.
[4] Alfred L. Malabre, Jr., *Beyond Our Means* (New York: Random House, 1987), p. xii.
[5] Paul Kennedy, *The Rise And Fall Of The Great Powers* (New York: Random House, 1987) p. 515.
[6] Ravi Batra, *The Great Depression Of 1990* (New York: Simon & Schuster, 1987). Also see his *Surviving The Great Depression of 1990* (New York: Simon & Schuster, 1988).

Keynesian, monetarist, supply-side, rational expectations, and Kondratieff models of the economy are too dogmatic, too rigid, and too simplistic.

As an alternative we offer New Wave Economics. It is an empirically-based framework which examines several important new trends in the economy; trends which have been largely ignored by the traditional models and the pessimists. New Wave Economics is not a radically new model of the economy. And it isn't a theory which explains observed economic behavior. Rather, New Wave Economics is an interdisciplinary approach which extrapolates several important social, political, economic, and demographic trends which are visible today into the 1990s.

The resulting outlook for the United States and other capitalist economies is very upbeat, in stark contrast to the dire predictions of the pessimists. Our optimistic forecast isn't intended to be a down-the-road scenario. We believe that most of the trends that we are projecting over the next five years are already underway.

Here are some of our more important New Wave conclusions and forecasts:

1) **Market capitalism will continue to proliferate and flourish in the global economy.** The prosperity created by the capitalist system is especially impressive in comparison to the stagnation of communist economies. The world economy will become more capitalistic as more countries deregulate their economies. Increasingly, the competitive market will replace state ownership and central planning. In capitalist societies, public policies will become more effective by harnessing rather than constraining market forces. Deregulation will spur global competition, which will become even more intense as the capitalist world becomes more multi-polar,. The US no longer dominates the capitalist world. Asian and European economies are as large as the North American economy. These markets will grow together; trade will expand; and, more material prosperity will be the result. Economic growth disciplined by global competition is not inflationary. *So growth should be sustainable.*

2) **Capitalism has never been more dynamic.** Capitalism produces change, and change is occurring more rapidly. Intense global competition is the major cause of the faster pace of capitalism. Managerial and technological innovations are occurring more frequently. New competitors are emerging in newly industrializing countries. Many businesses are successfully responding to the challenges of dynamic market capitalism; business planners and managers are learning that to survive and to prosper in the New Wave World they must adapt rapidly to the changes in the global marketplace. They recognize that their companies must produce and distribute goods and services in all the major capitalist markets. In the future, production will be almost as internationally mobile as financial capital. The proliferation of productive capacity around the world will intensify price competition, *so inflation should stay low.* To remain profitable, companies will continue to cut costs and to increase productivity. Prosperity will create labor shortages, but companies are more likely to boost capital expenditures than to inflate their labor costs by bidding up wage rates. *Capital spending should boom* and technological innovation should accelerate over the next

several years in the industrialized economies. (See Topical Study #11: *The Restructuring Of Corporate America Is Bullish*, December 9, 1987.)

3) **The markets should do a much better job of regulating the capitalist economies than policymakers.** Recessions should be less frequent and less severe than in the past. Of course, the booms and busts of the business cycle will remain a part of our economic lives. But market forces should dampen the booms. In the global credit markets, bondholders push yields up rapidly when they perceive an inflation threat. Such preemptive strikes reduce the likelihood that inflation will become a serious problem again. Therefore, severe busts will no longer be necessary to unwind the excesses caused by the booms; excesses won't be allowed to build in the first place.

In addition, capitalist economies are becoming more diversified and more resilient to shocks such as the global stock market crash of 1987. Major industries can fall into recession without depressing overall economic growth. *Rolling recessions that are limited to certain industries are more likely to occur than economy-wide recessions.*

Exchange rate movements can take quite a long time to fix trade imbalances among capitalist economies. But they do work eventually. *The US trade deficit should continue to narrow.* This is another achievement of the automatic adjustment mechanism of the marketplace.

4) **In the United States, powerful demographic forces related to the aging of the baby boom should push the personal savings rate toward 10% and the unemployment rate down to 4% within the next five years.** Consumer spending, which in real terms rose close to 5% per year on average from 1983 to 1986, should increase at half this pace over the next five years. *Home prices should climb at a much slower pace as the baby boomers settle down.* Capital spending should be very strong because the shortage of young new job seekers will force businesses to invest in labor-saving equipment. As the baby boomers move into their 30s and 40s over the next five years, their work ethic and productivity should improve.

Older baby boomers are likely to borrow less and save more. Some of these savings will go directly (or indirectly through bond funds) into government securities. Savings institutions should enjoy greater deposit inflows—and just at the point when the mad scramble for housing and mortgage credit of the 1970s and 1980s comes to an end. In other words, the traditional lenders to the housing market will have more money to invest at the same time that the demand for mortgage loans cools off. As a result, savings institutions are likely to increase their purchases of other credit market instruments, particularly US treasury securities.

We wouldn't be surprised if, by the end of the decade, investors complain about a shortage of bonds and nostalgically recall the days when yields were above 9%. Such a prospect is even more likely to become reality if the Social Security trust fund surpluses continue to swell as projected by the actuaries. *These surpluses combined with sustained economic* *growth and lower interest rates should balance the federal budget within the next five years.* (We investigated how the aging baby boomers are likely to affect the economy in Topical Studies #12, 13, and #14.)

II. The Wealth Of Nations

The central proposition of our New Wave approach is that Adam Smith's growth model of the competitive marketplace has never been more relevant and that capitalism has never been more dynamic than it is today. Adam Smith believed that the bigger the market, the greater the prosperity. The more producers, the more consumers. Free trade benefits everyone: "By opening a more extensive market for whatever part of the produce of their labour may exceed their home consumption, it encourages them to improve its productive powers, and to augment its annual produce to the utmost, and thereby to increase the real revenue and wealth of the society." (See Appendix.)

Today, the capitalist world is evolving into three enormous, interdependent marketplaces: (1) The North American bloc which is moving toward a free-trade association between the United States and Canada; (2) the newly industrialized countries of Asia led by Japan; and, (3) the unified economies of Western Europe, which by 1992 will be the greatest example of economic deregulation in world history.

Economic borders are expanding dramatically; they are less and less constrained by political borders. Markets are no longer national; they are international. Trade is becoming freer. Competition within and among the capitalist blocs is intensifying. New competitors are emerging within the newly industrializing countries. Countries like Thailand and Malaysia are emerging as new competitors in the global marketplace. And, of course, tremendous potential exists in China and India.

Market capitalism is regulating more and more of the world's economic activities. The national political establishments aren't resisting this development. On the contrary, they have been encouraging it through industrial and market deregulation, including privatization. In fact, on June 21, 1988 in Toronto, the leaders of the Group of Seven major industrial nations issued a declaration at the end of their annual economic summit conference which promised that they "will continue to pursue structural reforms by removing barriers, unnecessary controls and regulations; increasing competition, while mitigating adverse effects on social groups or regions; removing disincentives to work, save and invest, such as through tax reform; and, by improving education and training."

In the world we see, America is not a loser. Rather, America prospers along with the other capitalist nations because Americans are responding successfully to the global competitive challenges. If the Asian and European blocs are prospering at a more rapid pace, a pessimist could conclude that America is in decline: "If Japan is rising, America must be declining." But this view is based on a wrong assumption, namely, that the world economy is a zero-sum game. Competition does increase risk, but it also increases the rewards enormously by expanding the global marketplace. The three capitalist blocs are huge markets that will continue to grow together.

Some pessimists foresee a grimmer scenario. They see tremendous imbalances and tensions in the global economy. For example, Peter Peterson sees "vast differences in culture, history, and politics which make it just as hard for other industrial countries to do what we find natural (stimulate consumption) as it is for us to do what they find natural (stimulate savings)."[7] So he is skeptical that market forces alone can narrow the trade imbalances. Americans must consume less, save more, borrow less, and work harder. Or else, our standard of living will inevitably decline.

But market forces are working, in our opinion. People are changing in response to the global competitive challenges. All over the world, people share a desire to prosper. And increasingly they believe that capitalism is the means to that end. As trade becomes freer, the differences that Peterson worries about are likely to diminish. For example:

1) *Americans are working harder* and productivity is growing at a faster pace, particularly in manufacturing. The threat of deindustrialization forced us to make our businesses more productive so that we can compete in world markets. American companies are implementing Japanese cost-cutting techniques, such as just-in-time inventory management. American workers are settling for smaller wage gains so that their employers will stay in the USA. Quality and the work ethic are making a comeback. Demographic forces should slow consumption and boost savings.

2) *As the Japanese have prospered, they've come to recognize that they can afford to improve the quality of their lives.* They realize that they won't continue to prosper unless North Americans and Europeans are also prospering. That's why they'll continue to respond favorably to demands that they should consume and import more. Japanese companies responded to the soaring yen and plummeting exports by designing products that would be more appealing to their home customers. As the workweek gradually declines, consumers have more time to shop. And increasingly, they are shopping at discount stores that sell only imported products. Discounting, a great American tradition, is now becoming popular in Japan.

3) *South Korea's era of cheap labor is rapidly coming to an end.* Korean workers are proud of their country's success in global markets. And not surprisingly, they are demanding much higher wages. Last year's average increase was 17%.

4) *Even the Communists are starting to come around.* Under Mikhail Gorbachev's perestroika ("restructuring"), the Soviet economy will remain planned and, with small exceptions, publicly owned. But the Soviet leader wants more local initiative. According to Abel Aganbegyan, a key economic advisor to Mr. Gorbachev, "market relations in the

[7] Peterson, p.53.

USSR will be deepened and broadened" and centralized pricing will be retained only for the most essential products so that "free prices will grow significantly."[8]

Poland and Hungary are permitting more private enterprise. The Vietnamese have a new program of economic renovation, called *doi moi*, which encourages entrepreneurs to start their own small businesses and requires state companies to make a profit.[9] Boris Konte, vice governor of Yugoslavia's National Bank explains the forces working to reshape the whole communist landscape, "My country can't compete with your country without open borders and a free market. It isn't a matter of politics."[10]

Are the "workers of the world" on the verge of a great transformation? Yes, but it will probably take many, many years before the vast potential of consumers and producers in the communist world is set free from state control and central planning. For example, the Chinese, who are yearning to catch up with their Asian neighbors, have permitted the emergence of free markets, which now determine the prices of about half the country's output. But, at the end of September, in the face of rampaging inflation, China's leaders moved to strengthen centralized control of the economy.

As economic competition heats up around the world, military tensions seem to be easing. Wars and military outlays divert resources from the rest of the economy. There is a cease fire in the Persian Gulf and Iranians are trying to project a more moderate image. Iran and Iraq want to rebuild their economies fast. The soviets are pulling out of Afghanistan. In southern Africa negotiators are attempting to reduce regional violence. From Afghanistan to Angola, Mr. Gorbachev has implicitly acknowledged that the superpower game costs too much. So he is reducing his nation's "imperial overstretch," Americans will solve their overstretch problem by taking Professor Paul Kennedy's advise: We will persuade our allies to share our burden of European and Pacific defense more equitably. The prospects for a more peaceful and prosperous world have never been better.

III. The European Challenge

Today, the European Economic Community, which was first established in 1958 and has grown from 6 to 12 members, is poised for a great leap forward. At a 1985 summit meeting in Milan, the EEC governments approved the Single European Act, which would create an open market by the end of 1992. The act promises to remove about 300 major economic barriers. Most significantly, these barriers can be removed by "qualified majority voting" among ministers, rather than unanimity.[11] (The EEC's Council of Ministers adopts directives that are sent to national parliaments for ratification.)

---

[8] Abel Aganbegyan, *The Economic Challenge Of Perestroika* (Bloomington: Indiana University Press, 1988), p. 128.
[9] "Vietnam Revisited: Turn To The Right?" *Fortune*, August 1, 1988, pp. 84-102.
[10] "Protests Swell As Yugoslavia Economy Stalls," *The Wall Street Journal*, July 27, 1988, p.23.
[11] "Europe's Internal Market," *The Economist*, July 9, 1988.

Why did the Europeans agree to such an unprecedented and extraordinarily ambitious deregulation plan? They feared that they were falling hopelessly behind the United States and Japan. For example, the United States created 28 million jobs between 1970 and 1986, while the big Western European countries created next to none.[12] Since 1957, a web of red tape and regulations has gradually spread throughout the EEC. A truck driver needs 35 pages of invoices, customs declarations, and import statistical surveys to carry a load of goods from one end of the Continent to the other. Fragmented markets force the biggest manufacturer in Europe, Philips NV, to warehouse goods worth 23% of annual sales, while its consumer electronics counterparts in the US and Japan must tie up only 14% of their income on inventory.[13] European leaders hope that freer markets might cure what is commonly called "Eurosclerosis."

If the plan succeeds, the European Economic Community will be the world's greatest market. The potential is impressive: There are 320 million consumers in the EEC compared with 240 million in the US and 120 million in Japan. In 1987, the Community's gross domestic product was $4.2 trillion, almost equal to that of the US and well above the $2.7 trillion combined total of Japan, South Korea, Taiwan, Hong Kong, and Singapore.

Significant progress has been made already. For example:

1) As of March, 208 of 286 measures that the European Commission has listed as necessary to achieve market unification have been presented to the EEC Council of Ministers. So far 69, or 24%, of the directives have been adopted. The great majority should be approved by early next year, leaving almost four full years for ratification in the national parliaments before the end of 1992.

2) As a step toward permitting the freer flow of people, the EEC members approved a plan for mutual recognition of university degrees, so a doctor trained in Spain can work in Denmark and vice versa. By the end of next year, all new passports issued in Europe will be Euro-passports bearing the name of the country beneath that of the Community.

3) On June 13, 1988, the Community's finance ministers adopted a landmark plan to end capital controls. Individuals and companies will be permitted to open bank accounts outside their home countries and banks will be able to lend to foreigners without restrictions. Some EEC officials believe that financial deregulation will greatly increase pressure to establish a common currency managed by a European central bank.[14] Another consequence could be tax harmonization to minimize tax evasion, which would be facilitated by freer capital flows.

Taxes are the greatest obstacle to the formation of a one-market Europe. Value-added tax rates vary widely from country to country. High tax countries fear VAT-dodging by cross-

[12] *The Economist*, May 28, 1988, p. 50.
[13] B.J. Phillips, "Gearing Up For The New Europe," *Institutional Investor*, July 1988, pp. 47-55.
[14] B.J. Phillips, "Gearing Up For The New Europe," *Institutional Investor*, July 1988, pp. 47-55.

border shoppers. There seems to be a great deal of resistance to proposals that bring tax rates closer together.[15]

Still, the soaring rate of mergers and acquisitions, and the quicker pace of corporate restructuring reflect the business community's optimism about the 1992 outcome. *The Economist* (July 9, 1988) observed, "Now that most branches of European businesses are aware of it, 1992 has become a state of mind, a set of expectations that has political force, an obsession that amounts to a new reality." European companies are slashing costs to prepare for the more competitive era. Philips plans to cut 20,000 employees this year to save more than $100 million annually. European companies are forming joint ventures. French electronics giant Thomson and an Italian telecommunications company ended a long rivalry last year by merging their semiconductor manufacturing in response to fierce Japanese competition in the European chip market.[16] Mergers involving Community-based companies jumped 50% to 450 over the past year.[17]

IV. The Pacific Century?

Across the Pacific, changes are occurring which are just as significant as those that are underway across the Atlantic. The Europeans responded to the global competitive challenge by adopting the Single European Act, which targets the barriers to free trade that must be removed to create one market. In response to international pressures, the Japanese are making great progress in opening their domestic economy to foreign competitors. The blueprint for the deregulation of the Japanese economy is the Maekawa Report submitted to Prime Minister Yasuhiro Nakasone on April 7, 1986. The document, prepared by an Advisory Group headed by Haruo Maekawa, recommended a historic transformation of Japanese society.

Traditionally, most Japanese have believed that theirs was a poor, small, island nation with few natural resources and that everybody had to sacrifice to build it up. This overwhelming national consensus helps to explain why the Japanese have worked longer hours and saved more than their Western counterparts. Also, they've favored mercantilist economic policies which encouraged production and exports, and discouraged consumption and imports. This approach was extraordinarily successful, but in recent years most of the world started to see Japan as rich, powerful, greedy, and unfair. Resentment was especially strong in the United States because of the widening bilateral trade deficit with Japan. Protectionist sentiments in America threatened to disrupt Japan's export-led economy.

The Maekawa Report proposed a revolutionary restructuring of economic priorities including a radical deregulation plan. This remarkable document is based on two premises: (1) Japan must correct its trade imbalances to relieve international tensions which threaten to devastate Japan's economy, and (2) Japan is no longer poor, so it is time that the people

---

[15] "Shipwrecking 1992," *The Economist*, September 17, 1988, pp. 16-17.
[16] "Hands Across Europe: Deals That Could Redraw The Map," *Business Week*, May 18, 1987, pp. 64-65.
[17] "Merger Mania Strikes Europe As Barrier-Free Market Nears," *The New York Times*, August 26, 1988, p. 1.

enjoy the fruits of their country's prosperity. The Maekawa Committee recommended that Japan strive for economic growth led by domestic demand instead of exports. Active efforts should be made to encourage imports, particularly of manufactured goods.

The mercantilist approach was swept away. Japan was ready to join the capitalist world—to "strengthen the free trade system and to work for sustained and stable world economic growth." The Maekawa group established the following guiding principle:

> In order to make Japan more internationally open, policies based upon market mechanisms should be implemented from the viewpoint of "freedom in principle, restrictions only as exceptions." Accordingly, further improvement in market access and thorough promotion of deregulation should be carried out.

Japan's trading partners and critics were not impressed. The skeptics observed that the Japanese have a long history of broken promises to foreigners who pressured them to open their markets. During April 1987, the Reagan administration catapulted to tremendous political pressure at home and slapped a tariff on selected Japanese consumer electronics because the Japanese were violating a July 1986 semiconductor trade agreement with the US. *Time* noted that "Japanese behavior seemed to US officials to be part of a familiar Japanese attitude toward trade issues: delay followed by nominal agreement followed by intransigence."[18] C. Fred. Bergsten, director of the Institute for International Economics, summarized Washington's attitude toward the Japanese, "They give us very clearly the message that they only move when hit over the head by a two-by-four. So we will accommodate and hit them over the head."[19]

Despite these frustrations with the Japanese, the bashing is starting to produce results. Interest rates on loans from the Housing Loan Corporation have been lowered repeatedly. Earlier this year, the government abolished the tax exempt status of personal savings accounts, in an effort to reduce Japan's high savings rate. The Labor Standards Law was amended to gradually reduce statutory weekly working hours from 48 to 40. The government has called for longer summer vacations and has provided incentives to developers of new resorts. Since mid-1985, the Japanese abolished or reduced tariffs on nearly 2000 imported goods and eased standard requirements and certification procedures.

The effects of these efforts have been impressive. Domestic consumption is booming. Imported goods are selling particularly well. Last year, the Japanese built 1.6 million new homes, the most since 1973.

The Japanese were spurred to institute the Maekawa recommendations not only because they feared protectionism in America and Europe, but also because the yen soared in value relative to the dollar from 1985 to 1987. For years, the yen had been undervalued giving the Japanese a tremendous competitive advantage. In early 1949, during the occupation, American economic advisor Joseph Morrell Dodge pegged the exchange rate at 360 yen to

---

[18] "Trade Face-Off," *Time*, April 13, 1987, p. 35.
[19] Quoted in "A Mix Of Admiration, Envy And Anger," *Time*, April 13, 1987, p. 38.

the dollar, to revive the Japanese economy by boosting exports. The exchange rate was fixed at this ratio until 1971. The yen remained “cheap” until January 1986 when the dollar plunged below 200 yen. The Japanese called it the yen *shokku*.

Now, the Japanese are starting to worry about competition from newly industrializing countries. Last year, Japan became a net importer of textile products for the first time in recent history, with Korean imports currently accounting for more than half of the total. So Japan’s knitting industry is complaining that the Koreans are dumping sweaters in Japan.

The Koreans are dramatically expanding their capacity to produce steel, autos, and consumer electronics. Thailand is emerging as a newly industrializing country. The Taiwanese are making significant manufacturing investments in the Philippines. Malaysia is a major supplier of semiconductors.

So will the next century be the Pacific century as some fear? We doubt it. More likely, it will be the New Wave century. There won’t be one preeminent economic superpower. Rather the world will include many highly competitive capitalist economies, all prospering together.

Appendix

The Original Optimist

The roots of New Wave Economics are in Adam Smith's *The Wealth Of Nations*, which was first published in 1776. In Adam Smith's time, pessimism was as prevalent as it is today. Many essayists and pamphleteers were bemoaning the decline of Great Britain and predicting ruin for the country. Adam Smith sought to discredit the pessimists of his day by demonstrating how free markets foster economic growth and increase the wealth of nations. He believed that "universal opulence" was achievable through market capitalism. In Adam Smith's world, entrepreneurs are driven by self interest; they exchange their labor, goods, and services in the competitive marketplace; and, in the process, general prosperity results for all to enjoy. Amazingly, market capitalism transforms private self-interest into the public good.

Adam Smith observed that between 1660 and 1776, "five years have seldom passed away in which some book or pamphlet has not been published, written too with such abilities as to gain some authority with the public, and pretending to demonstrate that the wealth of the nation was fast declining, that the country was depopulated, agriculture neglected, manufacturing decaying, and trade undone."[1] The clamors of ruin were particularly loud after Britain won the Seven Years War in 1763, thus eliminating French influence and power in North America. The war was very expensive. Britain's post-war debt stood at 148 million pounds, with just over half representing the cost of the war. Much of this debt was owed to foreigners, particularly the Dutch.

The British reckoned that the American colonists were prosperous enough to help defray some of the costs of defending the colonies. In an effort to ease the debt crisis, the British Parliament imposed all sorts of taxes and duties on the colonists. With the rallying cry of "taxation without representation," the colonists resisted, and declared their independence in 1776.

Britain's pessimists were concerned about losing the American colonies or, perhaps worse, having to compete with emerging American manufacturers. (America was the equivalent of a newly industrializing country at the time.) Arthur Young writing in 1772 warned that events were leading to "the ruin of a vast part of our commerce and manufacturers…"[2]

Most social critics believed that Britain's debt would be the most likely cause of economic disaster. One essayist predicted that any "stroke of adverse fortune" could lead to "wretchedness and ruin." Arthur Young wrote that the "national debt will increase so much, that the payment of the interest to foreigners will impoverish the kingdom, at a time when exportation declines."[3]

---

[1] Adam Smith, *The Wealth Of Nations* (Chicago: University of Chicago Press, 1976 [1776], Volume 1, p. 365.
[2] Arthur Young, *Political Essays Concerning The Present State Of The British Empire* (London: W. Strahan and T. Cadell, 1772), p. 551.
[3] *Ibid*., p. 551.

Eighteenth century British public policy officials and intellectuals were in a rut. They saw problems, but they couldn't find solutions. So they anticipated ruin. They were operating under an obsolete world view based mainly upon mercantilist ideas. According to Eli F. Heckscher, mercantilists believed that "there was a fixed quantity of economic resources in the world, which could be increased in one country only at the expense of another."[4] This zero-sum assumption contributed not only to numerous commercial and colonial wars, but also to highly protectionist trade policies. Mercantilists favored bounties for exports and duties on imports. They wanted large trade surpluses because when a country sold more abroad than it purchased, it received the balance in gold and silver. Many mercantilists seemed to believe that the wealth of a nation was identical to the nation's supply of previous metals.

The same year that Americans declared their independence, Adam Smith published his five-book masterpiece, *An Inquiry Into The Nature And Causes Of The Wealth Of Nations.* Adam Smith argued that mercantilist policies were the cause of Britain's rut. The way out of the ditch was to abandon such zero-sum policies. Barriers to free trade should be eliminated because they tended to "force the trade of a country into a channel much less advantageous than that in which it would naturally run of its own accord."[5] He condemned the enforcement of exclusive trade with the colonies because the resulting artificially high profits attracted capital away from more productive uses.[6] In fact, in the final paragraph of his inquiry, Smith concluded that Britain would be better off without the colonies!

Adam Smith argued that a nation's wealth increases as employment, production, incomes, and consumption increase. Economic growth, not the supply of precious metals, creates prosperity.

In addition to demolishing mercantilism, Adam Smith sought to demonstrate that the pessimists were wrong about Britain's future. Britain was not in decline. Rather, the mercantilists had unknowingly constrained the nation's potential for growth. The proof of that potential was self-evident: He observed that while the mercantilist approach of the "government must, undoubtedly, have retarded the natural progress of England towards wealth and improvement, it has not been able to stop it."[7] The country continued to prosper despite the "exactions of government."

Individuals in pursuit of bettering their own conditions constituted an incredibly powerful economic force. If growth could occur under the heavy burden of mercantilists policies, he suggested, imagine what would happen if mercantilism were eliminated.

What did happen was the Industrial Revolution. And Britain—the same Britain which numerous pessimists had insisted was in decline—asserted her supremacy in the world econ9omy for at least another century.

---

[4] Eli F. Heckscher, *Merchantilism*, translated by Mendel Shapiro (New York: MacMillan Company, 1962 [1931, 1955], Vol. 1, p. 22.
[5] Smith, *The Wealth Of Nations*, Vol. II, p. 11.
[6] *Ibid.*, pp. 109-112.
[7] *Ibid.*, Vol. I, p. 367.